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Judgment of the Court of Justice in Case C-196/04

*Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*

### **UNITED KINGDOM LEGISLATION ON CONTROLLED FOREIGN COMPANIES CAN APPLY ONLY TO WHOLLY ARTIFICIAL TAX ARRANGEMENTS**

*In order to determine whether a CFC is carrying on a genuine activity, the national authorities should take account of objective factors which are ascertainable by third parties, and not only subjective considerations*

Under United Kingdom tax legislation, the profits of a foreign company in which a UK resident company owns a holding of more than 50% (known as a controlled foreign company, or CFC) are attributed to the resident company and subjected to tax in the UK, where the corporation tax in the foreign country is less than three quarters of the rate applicable in the United Kingdom. The resident company receives a tax credit for the tax paid by the CFC. That system is designed to make the resident company pay the difference between the tax paid in the foreign country and the tax which would have been paid if the company had been resident in the United Kingdom.

There are a number of exceptions to the application of that legislation, inter alia where the CFC distributes 90% of its profits to the resident company or where the 'motive test' is satisfied. In order to obtain the latter exception, a company must show that neither the main purpose of the transactions which gave rise to the profits of the CFC nor the main reason for the CFC's existence was to achieve a reduction in UK tax by means of the diversion of profits.

Cadbury Schweppes plc is the parent company of the Cadbury Schweppes group which operates in the drinks and confectionery sector. The group includes, inter alia, two subsidiaries in Ireland, Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI), which are established in the International Financial Services Centre (IFSC) in Dublin, Ireland, where in 1996 the tax rate was 10%. Those two companies are responsible for raising finance and providing that finance to the group. In the view of the national court, CSTS and

CSTI were established in Dublin solely to take advantage of the favourable tax regime of the ISFC and in order not to fall within the application of certain UK tax provisions.

In 2000 the Commissioners of Inland Revenue, taking the view that the CFC legislation applied to the two Irish companies, claimed corporation tax from Cadbury Schweppes of £8 638 633.54 on the profits made by CSTI in 1996.

Cadbury Schweppes appealed before the Special Commissioners of Income Tax, maintaining that the CFC legislation was contrary to Community law, in particular in the light of freedom of establishment. The Special Commissioners asked the Court of Justice whether Community law precluded rules such as the CFC legislation.

The Court recalls that companies or persons cannot improperly or fraudulently take advantage of provisions of Community law. However, the fact that a company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute an abuse of the freedom of establishment. Therefore the fact that Cadbury Schweppes decided to establish CSTS and CSTI in Dublin for the avowed purpose of benefiting from a favourable tax regime does not in itself constitute abuse and does not prevent Cadbury Schweppes from relying on Community law.

The Court notes that the CFC legislation involves a difference in the treatment of resident companies on the basis of the level of taxation imposed on the company in which they have a controlling holding. That difference in treatment creates a tax disadvantage for the resident company to which the CFC legislation is applicable. **The CFC legislation therefore constitutes a restriction on freedom of establishment within the meaning of Community law.**

As regards the possible justifications for such legislation, the Court points out that a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed solely at escaping national tax normally due and where it does not go beyond what is necessary to achieve that purpose.

Certain exceptions in the UK legislation exempt a company in situations in which the existence of a wholly artificial arrangement solely for tax purposes appears to be excluded (for example distribution of 90% of a subsidiary's profits to its parent company or performance by the SEC of trading activities). As regards the application of the 'motive test', the Court notes that the fact that the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of transactions between the CFC and the resident company does not suffice to conclude that there is a wholly artificial arrangement. In order to find that there is such an arrangement there must be, in addition to a subjective element, objective and ascertainable circumstances produced by the resident company with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment, showing that the incorporation of a CFC does not reflect economic reality, that is to say it is not an actual establishment intended to carry on genuine economic activities in the host Member State.

**It is for the Special Commissioners to determine whether the motive test lends itself to an interpretation which takes account of such objective criteria. In that case, the legislation on CFCs should be regarded as being compatible with Community law.** On the other hand, if

**the criteria** on which that test is based **mean that a resident company comes within the scope of application of that legislation, despite the absence of objective evidence** such as to indicate the existence of a wholly artificial arrangement, **the legislation would be contrary to Community law.**

*Unofficial document for media use, not binding on the Court of Justice.*

*Languages available: FR CS DE EN ES HU IT NL PL SK SL*

*The full text of the judgment may be found on the Court's internet site*

*<http://curia.europa.eu/jurisp/cgi-bin/form.pl?lang=EN&Submit=rechercher&numaff=C-196/04>*

*It can usually be consulted after midday (CET) on the day judgment is delivered.*

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